Overseas Market and Home Market

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The wisdom preached by the International Monetary Fund (IMF), the World Bank and nearly all mainstream economists during the past quarter-century of what has been (mistakenly) called ‘neo-liberalism’ has been that economies open to trade, capital and investment flows from around the world –in obedience to the laws of the putatively ‘free’ market–grow and develop faster and, hence, can bring about a quicker reduction in poverty, via the famous ‘trickle-down effect’, than can other economic approaches. This has been the essence of what is called globalisation. Textbook theory, it has been argued, shows very convincingly that both sides to a trading contract (both within and across countries) gain from it. Such ‘efficiency’ gains constitute the necessary incentive for spurring investment and growth within economies.

Theory is one thing, however, while reality quite another. The above wisdom today lies shattered as the ‘great financial crisis of 2008’ threatens to throw economies around the world into a serious depression–one that could last for years, such as took place during the 1930s. Trade, as an engine of growth and poverty reduction, now has to be questioned.

In January 2009, world trade was 17 percent lower compared to January 2008. Monthly data can be volatile, so one may want to consider the average of three months at a time. Even so, world trade during November 2008 to January 2009 was 40 percent lower than during the previous three months, calling forth (as compensation for serious shortfalls in demand) enormous, historically unprecedented ‘stimulus packages’–fiscal, monetary and financial–from governments everywhere.

Many explanations have been offered for this collapse of trade. First, the bursting of the housing bubble in the US in August 2007 led to a rapid fall in consumer wealth in the country, as home equities fell in value. This led to a dramatic fall in consumer demand. The American consumer has been the key source of demand for exports from elsewhere, especially from China, East Asia and, more recently, India. (This has been financed by the savings of China, East Asia and the petroleum-exporting countries that have been invested in the US.) One out of every six or seven dollars spent in the world economy comes from the American consumer, there is, therefore, no immediate substitute for the United States.

Second, the massive collapse of financial markets around the world in the wake of the bankruptcy of giants of investment banking such as Lehman Brothers and Merrill-Lynch, in September 2008, has brought about systematic ‘de-leveraging’ by financial institutions. This has caused a credit freeze everywhere, especially in the US and the other Western economies. At the moment, no one wants to lend, for any purpose. Any monetary or financial infusion is being absorbed by banks and financial institutions keen to draw their debts down in a time of great uncertainty. Third, the implication of this for international trade can hardly be overstated. Images of cars and other cargo piling up at harbours around the world have become common. What is behind this is the fact that the letters of credit from banks (traditionally offered against the advance delivery of goods) have become very hard for ship-owners to obtain, due to the climate of uncertainty that has been generated by the financial crisis.

In November 2008, the World Bank predicted that the global economy would grow by one percent in 2009. Now, it is expected to shrink by about 1.5 percent. It had also predicted a 9.2 percent growth rate for the Chinese economy for 2009. Sometime later, it revised this downwards to 7.5 percent. A few weeks back, it was lowered further, to 6.5 percent. Forecasts of Chinese growth for 2009 now range from 5.5 to 8 percent, down from an actual 13 percent in 2007 and 9 percent in 2008. For China, growth below 8 percent is conventionally seen as perilous from the point of view of maintaining political stability, since the creation of jobs in the cities fails to keep pace with the influx of migrants from the countryside at a lower rate of growth than that.

For India, the World Bank in its latest estimate has slashed the growth forecast from 5.8 percent to 4 percent for 2009-10. Meanwhile, the data for 2008-09 shows 5.5 percent growth, as opposed to the 7.1 percent predicted. The developing world as a whole is expected to grow by a mere 2.1 percent this year, as compared to 5.8 percent last year.

China's fortunes are obviously tied up with that of the world economy. This should surprise no one. Other than the fact that its savings have been financing overspending by the US for the past few decades, exports make up about 38 percent of China's gross domestic product, and have constituted the catalyst for its stunning growth over the past few decades. Thanks to the massive recession in the West and in Japan, these have been falling consecutively for the past five months, at 17-26 percent on a year-on-year basis.

In India, exports have been declining over the past six months at an annual rate of 15-20 percent, plummeting by as much as 31 percent year-on-year in March 2009. Perhaps the only saving grace is that imports have declined by even more –by 37 percent–by March, though this only signals the fact that New Delhi policymakers are in severe denial: the Indian economy is in recessionary mode by any rational yardstick befitting a so-called emerging economy.

The first country to inject a fiscal stimulus into its economy in order to negotiate the global economic crisis was China. Beijing is spending upwards of USD 600 billion over the next few years to make up for the falling demand for its exports from the US and the Western world. However, according to the Asian Development Bank, this is not likely to generate the desired number of jobs, since infrastructure spending is not as labour-intensive as investment in manufacturing. Reversing his agency's traditional prescriptions calling for reducing the role of the government in the economy, the World Bank country director for China, David Dollar, said in March that state initiatives to stimulate consumption and improve living standards by expanding government spending on health, education and social protection measures were welcome in this time of crisis. Shifting China's output from exports to domestic demand would help to provide immediate stimulus, he argued, while laying the foundation for sustainable growth in the future.

Short of actually admitting to the exhaustion of the export-led growth model of East Asian capitalism, the World Bank–one of the original advocates of the model–has said everything else. This is one of the most important lessons of the growing economic crisis around the world. A generation of thinking and policy-making in support of export-led growth now has to be set aside. Of course, this does not mean that immediate protectionism is called for– that would be disastrous, and it is already beginning to happen. But over a period of time, large developing economies such as India's and China's will have to re-orient policies to build their respective home markets.

CNN reported a few months back that over 20 million migrant workers in China have returned to their villages since the recession began in early 2008 (other estimates are somewhat higher). Anywhere from 25 to 35 million people may have lost their jobs in China over the past year alone. Every percentage-point loss in China's growth rate amounts to over five million jobs lost, according to the World Bank. Thousands of factories have shut down in southern China alone, thanks to the collapse of exports to the US and the West. Meanwhile, the International Labour Organisation predicts that global job losses this year could top 50 million.

If India has suffered less than China on this count, it is because it is less integrated within the world economy. Exports constitute only about 20 percent of India's economy, compared to almost twice that proportion for China. Countries more integrated with the world economy, such as Japan, Taiwan and South Korea, have suffered far steeper falls in exports, growth and employment. In Taiwan, for example, exports have fallen by 25 to 40 percent year-on-year every month since the recession began.

While data is hard to come by (the general election having put an effective lid on the release of bad news), news reports suggest that upwards of a million, and possibly up to three million, jobs may have already been lost in India since the recession officially began six months ago. Migrant workers from Bihar, Assam, Orissa and Jharkhand, working in mills and workshops in Maharashtra and Gujarat, have returned home–where there are no jobs either. Apart from the white-collar jobs lost in the service economy, job losses have happened in textiles, leather goods, gems and jewellery, handicrafts, among other export sectors. In keeping with the overall trend, the index of industrial production has been falling for a while. In fact, the rural economy–forgotten for years until just some months ago–is now being looked upon as a potential saviour.

There was a time not so long ago when some economists and policy-making elite, including in India, were hoping for a 'decoupling' from rich economies who were suffering the collapse of financial and credit markets. There was even talk at one stage of India and China together being able to buoy up the sagging world economy, as if the American consumer could simply be substituted. But no one was complaining when 'easy money' policies in the West allowed the Indian economy to grow at unsustainable speeds between 2003 and 2008. Under such circumstances, as China is learning, decoupling is an illusion, especially since financial markets are closely interlinked and move, by and large, together.

There is, of course, the added pressure of protectionism. No matter how much the G20 leaders may officially pledge to avoid it, the truth lies elsewhere. The US under President Barack Obama is trying to protect its service-sector jobs by shutting out skilled workers from other countries (thereby adversely affecting remittances). Again, in an attempt to protect domestic jobs, stiffer environmental standards are being applied by the US and the EU in order to keep imports from low-wage economies under check. Buy American provisions have been included in the American stimulus package, and there are similar pressures, quietly but surely, emanating from other rich countries.

India, distinct from China and East Asia, has the added pressure of an increasingly adverse balance-of-payments situation. New Delhi's trade deficit is now some USD 30-40 billion every quarter. During the last quarter, the current-account deficit reached USD 14.5 billion. These numbers should be seen from the perspective of rapidly declining imports–a sure sign of falling domestic demand and recession–and the low price of oil since the recession began.

Technically, India has the hard-currency reserves to negotiate such payments difficulties. And yet, from USD 315 billion at the start of the recession, the reserves are now down to USD 245 billion, thanks to the fall in exports and the outflow of capital that has taken place during the last six months, as Western banks and financial firms have needed cash to draw down their debts. From their point of view, it is irrelevant whether the fundamentals of the Indian economy are strong or not. In such a context, one has to be thankful that the eagerly awaited convertibility of the rupee on the capital account–which would have enabled far greater outgo of capital from the country–has not happened yet. Such a major change in financial legislation in India–precisely in the direction of the financial deregulation, which has caused the gigantic mess in global finance–would be to commit hara-kiri. It would smoothen the path for speculation in a highly volatile environment.

If India were to hit a major payments barrier in the next few years, its position would not be too dissimilar to that of Pakistan, which has yet again been forced to look to IMF assistance to pay for essential imports. This would also mean that there will be further conditionalities imposed on the country's policy-making.

For the foreseeable future, one has to reckon with the reality of globalisation, even if the longer term may open up new possibilities. The mistake that Indian policymakers have been making is in having open-door policies for everything. A doctrinaire faith in free markets is exactly what the present crisis has shown to be so deadly.

One silver lining in the Chinese darkness is that its banking sector has remained largely unscathed amidst the global financial crisis, even while its equity markets have, of course, gone down sharply, as elsewhere. Behind this are strict capital controls–going against what the IMF has 'successfully' prescribed for so many countries and brought so much for them. Despite enormous pressures from the West, China has kept tight control over its currency, refusing to revalue the yuan or open up its capital account to international speculators.

There is a lesson here for India. Thanks to a prudent central bank, India has traditionally had a well-regulated financial sector. It must stay that way, instead of succumbing to the very strong long-standing pressures for financial liberalisation emanating from the portals of global finance. These pressures are not letting up, even in the face of what may turn out to be history's worst financial crisis. As regards trade in real goods and services, both India and China must learn the sobering lesson that growth that relies on overseas markets is fraught with uncertainties and instabilities, especially in crisis times. There is no alternative to building the home market–which is, in effect, what even the World Bank is now saying. In any case, the goal of 'development' currently seems to be to enable the poor and working classes in these countries to consume more.

Much is made of the similarities between India and China. The reality is quite different. Apart from high populations and the short-term rates of growth of their respective economies, the two have little in common. The structure and character of the economies, as much as the nature of the state's role in each, are dramatically different. China has been running an export surplus vis-à-vis the West for the better part of a generation now, so much so that its investment in US Treasury bonds is blamed by some to be at the root of the financial crisis for having allowed a low interest-rate regime.

India, by contrast, has been consistently running trade deficits. It has been able to pay for its excess imports only by relying on capital inflows from overseas, thanks to investor-friendly policies. India's foreign reserves are today only about 20 percent of China's. More importantly, India's reserves are made up of capital inflows, rather than a trade surplus, as is the case with China. Hence, India is far more vulnerable to predatory finance than is China. If the reserves come from net export revenues, the money belongs to residents of the country. If they are based on capital inflows, the money does not belong, strictly speaking, to the residents of the country over the long term. This means that foreigners or non-resident citizens have decided to 'park' the money temporarily in the assets of the country. If the mood changes (as it has in the last year, quite dramatically), the money could as easily be taken out of the country (as it has in the last one year from India). This is the wisdom behind strict capital controls in China. If one invests in the country's assets, money is locked in there for a long time, unlike what it would be with greater capital mobility, as Indian policy elites have been trying to engineer.

China's manufacturing output (as well as employment) is several times that of India's in almost every sector. The People's Republic continues to enjoy the results of big investments in health and education that were made before the reforms began 30 years ago (though this trend is being reversed rapidly now). India has never made these investments. The examples of differences between the two are therefore many. The illusion that these two countries have a common economic destiny is fed by global finance, which considers paper investments in both countries on the same spreadsheet: from the vantage point of Wall Street investors, China and India are two large circles on the financial map of the world. The two countries compete with each other to attract funds from global investors. Their stock markets provide some of the highest returns anywhere in the world. Sometime back, before the financial collapse of the past year, the Dalal Street Stock Exchange in Bombay was yielding on average 43 percent return per annum to investors, a good 10 percentage points above the Shanghai Stock Exchange, and almost 30 percentage points more than the New York Stock Exchange. Using such superficial data, the business media in India has further promoted the myth of 'Chindia'.

When all is said and done, in the kind of world to which the oncoming depression is likely to give birth, it will be crucial that both India and China build their home markets with appropriate policies. In this 'new world', consumers in rich countries, especially in the US, are changing their purchasing behaviour quite radically. Gone are the days of debt-based consumption, banking on the high value of homes. Everyone is going to be de-leveraging for the foreseeable future. Rich-country consumers are thus likely to continue to cut their demand for products from low-wage economies; and they would thus be the wrong economic constituency on which to build a growth strategy. The days of export-led growth are now over.

For the home market to be built in a sustainable manner, growth must be the product of secure employment generation in the domestic economy, instead of the other way around. To rely on the fortunes of consumers in the rich countries to fuel growth in these economies is to fail to notice the disaster that export-led growth has become. A radical change of course is clearly called for. In this respect, Chinese policymakers are farther ahead of the game than are their counterparts in countries like India.

There are other important reasons–chief among them being the environmental crisis and the worsening income distribution–as to why steps in the direction of 'de-globalisation' should be welcome in both countries. However, there are reasons enough stemming from the economic situation in which these countries find themselves today. The central difference between the Indian and the Chinese state establishments today is that the latter has begun to digest this truth, while the former has not. Beijing is going back towards its policy, from the 1980s, of generating jobs in the countryside–through town and village-based enterprises–which, rather than economic globalisation, was the true secret of poverty reduction in the country. New Delhi, meanwhile, is yet to see the light. □□□

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